

# Tulsa Law Review

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Volume 33  
Issue 3 *Mineral Law Symposium*

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Spring 1998

## Union Pacific Fuels, Inc. v. FERC: The FERC's Ability to Abrogate Natural Gas Transportation Contracts

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### Recommended Citation

Harold G. Drain, *Union Pacific Fuels, Inc. v. FERC: The FERC's Ability to Abrogate Natural Gas Transportation Contracts*, 33 Tulsa L. J. 931 (2013).

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## **UNION PACIFIC FUELS, INC. v. FERC: THE FERC'S ABILITY TO ABROGATE NATURAL GAS TRANSPORTATION CONTRACTS**

### **I. INTRODUCTION**

"[T]he law of contracts permeates every aspect of our society."<sup>1</sup> It reaches into our daily activities, such as, employment, purchases, and sale of goods.<sup>2</sup> When the language of a contract is not drafted in a clear and specific manner, the intentions of the parties' bargain may be jeopardized. By using careful draftsmanship, parties to contracts for transportation of natural gas can avoid such a possibility.

When drafting a contract for the services of a natural gas pipeline, several doctrines, if followed, ensure that the bargained risk allocation will not be abrogated by an act of the Federal Energy Regulatory Commission ("FERC" or "Commission"). The *Mobile-Sierra* doctrine<sup>3</sup> and the *Memphis Clause*<sup>4</sup> were discussed in *Union Pacific Fuels, Inc. v. FERC*<sup>5</sup> ("*Union Pacific*"). In *Union Pacific*, parties to a natural gas contract anticipated intervention by the FERC. In this case, the FERC interpreted the contract in a manner counter to the parties' intent. This Note, while analyzing the *Union Pacific* case, focuses on the influences that major doctrines, such as the *Mobile-Sierra* doctrine and the *Memphis Clause*, have on a drafter of a natural gas transportation contract. Part II provides a basic overview of the *Mobile-Sierra* doctrine, introducing the reasons for the enactment of the FERC Order No. 636,<sup>6</sup> while evaluating changes the Order made to the industry. Part III discusses the factual and proce-

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1. JOHN CALAMARI & JOSEPH PERILLO, HORNBOOK ON CONTRACTS 5 (3rd ed. 1987). This book provides a general discussion of the law of contracts. See also SCOTT AND LESLIE, CONTRACT LAW AND THEORY (2nd ed. 1993).

2. HORNBOOK ON CONTRACTS, *supra* note 1, at 5.

3. The *Mobile-Sierra* doctrine "imposes a higher standard on the Federal Energy Regulatory Commission before it can abrogate private contracts under section five of the [Natural Gas Act]." Joint Initial Brief of Petitioners at xvi, *Union Pac. Fuels, Inc. v. FERC*, 129 F.3d 157 (D.C. Cir. 1997) (No. 93-1463). The Natural Gas Act, 15 U.S.C. § 717(d) [hereinafter "NGA"], "regulate[s] the transportation and sale of natural gas in interstate commerce." MANUAL OF OIL AND GAS TERMS 666 (9th ed. 1994). The subject matter of section five of the NGA, deals with fixing rates and charges by the Commission and the determination of cost of production or transportation. 15 U.S.C. § 717(d) (1997).

4. This doctrine provides parties the opportunity to allow the FERC to change a contract if the contract anticipates such intervention. *Union Pac. Fuels, Inc. v. FERC*, 129 F.3d 157, 160 (D.C. Cir. 1997).

5. See *id.*

6. Order No. 636, *Pipeline Service Obligations and Revisions to Regulations Governing Self-Implementing Transportation Under Part 284 of The Commission's Regulations, and Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, III F.E.R.C. STATS. & REGS., Preambles & 30,939, 57 Fed. Reg. 13,267 (1992) (codified at 18 C.F.R. Part 284) [hereinafter Order No. 636].

dural background of *Union Pacific*, while analyzing the effects of Order No. 636 on both parties. Part IV scrutinizes *Union Pacific*, postulating implications on future contracts and evaluating the court's holding. Part V summarizes the drafting lessons to learn from the *Union Pacific* decision. This Note concludes that: (1) the *Union Pacific* court properly decided the case by enforcing the contract as written; (2) the FERC's power should not be curtailed simply because parties fail to draft their contract to clearly reflect the intended allocation of risk; and (3) the drafters of natural gas transportation contracts can learn a valuable lesson as to what interpretations are attached to various contract terminology (such as the *Memphis Clause*) and thus avoid costly drafting errors.

## II. BACKGROUND

### A. In General

Contracts reflect the parties' agreement concerning the distribution of risk allocation. When a contract is consummated, the parties meet to bargain for mutually beneficial terms. They rely upon the terms in the contract, and use those terms to make future business decisions. If the FERC has the authority to abrogate such a private contract, large economic impacts on all companies involved in the buying, selling, or transporting of natural gas could result. The impact of the regulatory sword can cause economic harm to any party in the agreement. Therefore, understanding the limitations placed on the Commission in exercising this authority, while knowing how to avoid regulatory intervention, is necessary for one who drafts contracts with natural gas pipelines. One such limitation on the Commission's power to interfere with a private contract is known as the *Mobile-Sierra* doctrine.<sup>7</sup>

On February 27, 1956, the United States Supreme Court issued two landmark decisions<sup>8</sup> establishing what is known as the *Mobile-Sierra* doctrine. These opinions restrained the FERC's authority to interfere with an existing private contract.<sup>9</sup> Under the *Mobile-Sierra* doctrine the Commission has the authority to abrogate the contract only if the public interest demands it.<sup>10</sup> The doctrine was subsequently modified to allow contract intervention by the Commission when parties anticipate such intervention in their contract. Therefore, the FERC may not interfere with a private agreement unless: 1) public interest demands it; or 2) the parties stipulate through contract to allow such intervention by the FERC.

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7. See *Mobile-Sierra* doctrine, *supra* note 3.

8. See *FPC v. Sierra Pac. Power Co.*, 350 U.S. 348 (1956); *United Gas Pipe Line Co. v. Mobile Gas Corp.*, 350 U.S. 332 (1956).

9. See *id.* Prior to the *Mobile-Sierra* doctrine, all the Commission needed to interfere with private contractual arrangements was a belief that the proposed rate was 'just and reasonable.' See *Mobile Gas Corp.*, 350 U.S. at 337, 338.

10. See *Union Pac.*, 129 F.3d at 161.

## B. Development of the Mobile-Sierra Doctrine

### 1. *United Gas Pipeline Company v. Mobile Gas Service Corporation*

In 1953, Mobile Gas Service Corporation ("Mobile") brought an action against the United Gas Pipeline Company ("United") due to United's unilateral action to raise its rates.<sup>11</sup> The contract at issue, signed in 1946, provided for Mobile to acquire its gas from United at a set price for ten years.<sup>12</sup> United properly filed the contract with the Federal Power Commission ("FPC").<sup>13</sup> Seven years after the original contract was filed, United filed a new rate schedule<sup>14</sup> with the FPC, requesting an increase in its resale rates to Mobile.<sup>15</sup> Mobile argued that United acted improperly by failing to obtain Mobile's consent to the change. Mobile claimed United could not unilaterally change the agreed upon contract rate.<sup>16</sup>

The sole issue was whether it was unconstitutional to interpret the Natural Gas Act ("NGA") to allow a natural gas company to unilaterally, through action of the FPC, change the rate of an existing contract.<sup>17</sup> The Supreme Court stated that the NGA can be explained as "defining and implementing the powers of the Commission to review rates set initially by natural gas companies, and there is nothing to indicate that they were intended to do more."<sup>18</sup> The Court held under the NGA, that a natural gas company could not, without the consent of the distributor, change the rate of a long-term contract.<sup>19</sup> The significance of the decision was its ruling that the FPC should not have the authority to abrogate a contract of two private parties unless the contract rate is so low that the public interest would be adversely affected.<sup>20</sup>

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11. See *Mobile Gas Corp.*, 350 U.S. at 335.

12. See *id.*

13. In 1977, as a result of the Department of Energy Organization Act, Pub. L. No. 95-91, § 402(a), 91 Stat. 565, 583-84, the regulatory functions of the Federal Power Commission was transferred to the newly created Federal Energy Regulatory Commission (codified at 42 U.S.C. §§ 7101-7382f (1994)).

14. The FERC is responsible for determining whether rates are just and reasonable:

Whenever the Commission, after a hearing had upon its own motion or upon complaint of any State, municipality, State commission, or gas distributing company, shall find that any rate, charge, or classification demanded, observed, charged, or collected by any natural-gas company in connection with any transportation or sale of natural gas, subject to the jurisdiction of the Commission, or that any rule, regulation, practice, or contract affecting such rate, charge, or classification is unjust, unreasonable, unduly discriminatory, or preferential, the Commission shall determine the just and reasonable rate, charge, classification, rule, regulation, practice, or contract to be thereafter observed and in force, and shall fix the same by order.

15 U.S.C. § 717d(a) (1997).

15. See *Mobile Gas Corp.*, 350 U.S. at 335.

16. See *id.* at 336.

17. See *id.* at 337.

18. *Id.*

19. See *id.*

20.

The basic power of the Commission is that given by section 5(a) [of the NGA] to set aside and modify any rate or contract which it determines, after hearing, to be 'unjust, unreasonable, unduly discriminatory, or preferential' . . . it is simply the power to review rates and contracts made in the first instance by natural gas companies and, if they are determined to be unlawful, to remedy them.

*Mobile Gas Corp.*, 350 U.S. at 341.

## 2. *Federal Power Commission v. Sierra Pacific Power Company*

Unlike *Mobile* in the case just discussed, *Sierra Pacific Power Company* distributed electricity, not natural gas, to consumers in Nevada and California.<sup>21</sup> A dispute arose as the result of a fifteen-year contract to purchase power from Pacific Gas and Electric ("PG&E").<sup>22</sup> In 1953, just five years into the contract, PG&E unilaterally filed a request for a rate increase with the FPC.<sup>23</sup> Like *United* in *Mobile*, PG&E failed to obtain the consent of *Sierra*.<sup>24</sup> The court's reasoning for its decision was similar to that in *Mobile*. The court ruled that the reason for the FPC's existence is to change an existing rate contract only if it is unjust, unreasonable, or preferential.<sup>25</sup> The court concluded the issue is not whether a rate is low, but whether it is so low as to adversely affect the public interest.<sup>26</sup>

## 3. *United Gas Pipeline Company v. Memphis Light, Gas and Water*

Two years after the *Mobile* and *Sierra* cases were decided, the United States Supreme Court decided to further clarify the *Mobile-Sierra* doctrine. At issue in *United Gas Pipeline Co. v. Memphis Light Gas & Water* was a long term gas contract between *United*<sup>27</sup> and *Memphis Light, Gas and Water Company*, a division of *Texas Gas Transmission Corporation* (*Texas Gas*),<sup>28</sup> which involved a mandated use of a rate schedule, rather than negotiate a specific price.<sup>29</sup> The price was to reflect the Seller's Rate Schedule or "any effective superseding rate schedules, on file with the Federal Power Commission."<sup>30</sup>

In 1955, without the permission of *Texas Gas*, *United* filed a new rate schedule with the Commission to increase the price of its gas.<sup>31</sup> The Commission ordered a hearing in which *Texas Gas* argued *United*'s request ran contrary to the *Mobile-Sierra* doctrine.<sup>32</sup> The Commission distinguished the case from *Mobile*, arguing that the contracts differed substantively.<sup>33</sup> The contract in *Mobile* involved a specific price whereas the contract in *Memphis* was ambiguous as to the calculation of how the price would be computed.<sup>34</sup> The Commission could follow the rate schedule proposed by *United* at the time of contract formation, or base the price on any "going rate" filed with the Commission.<sup>35</sup> The

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21. See *Sierra Pac. Power Co.*, 350 U.S. at 351.

22. See *id.* at 352.

23. See *id.*

24. See *id.*

25. This is the condition precedent to the Commission's exercise of its power under section 206(a). See *id.* at 353.

26. See *id.*

27. *United Gas Pipeline Corporation* is the same company involved in the *Mobile* case.

28. See *United Gas Pipe Line Co. v. Memphis Light, Gas & Water Div.*, 358 U.S. 103, 106 (1958).

29. See *id.* at 105.

30. *Id.*

31. See *id.* at 106.

32. See *id.*

33. See *Memphis Light, Gas, & Water Div.*, 358 U.S. at 110.

34. See *id.*

35. *Id.*

contract bound United to provide gas to Texas Gas for the length of the contract at the going rate.<sup>36</sup> In *Mobile*, the Court held that United bargained away its right to change the rate of the contract.<sup>37</sup>

*Memphis* refined the *Mobile-Sierra* doctrine by holding that the Commission has the authority to modify a contractual rate schedule and allow a company to amend its express contract rates. This can be done without the affected party's consent, as long as intervention is an option contemplated in the contract. In *Memphis*, the parties placed a clause in the contract which anticipated using prices set by the Commission.<sup>38</sup> By refining the *Mobile-Sierra* doctrine, the Court acknowledged the authority of the Commission to abrogate or modify contracts.<sup>39</sup> Not only could the Commission interfere with the contract if the public interest demanded, but it could now intervene if the contracts anticipated intervention.

### C. Order No. 636

The FERC's power to interfere with private contract rates by way of the *Mobile-Sierra* doctrine has been the subject of recent challenges to FERC actions.<sup>40</sup> Over the last two decades, there has been a movement to deregulate the natural gas industry,<sup>41</sup> which has resulted in a progression of FERC Orders aimed at deregulation.<sup>42</sup> These orders have had a major impact on the transportation of natural gas.

Order No. 636 was perhaps the most significant of these orders, which the Commission proposed in 1993 attempting to level the playing field in the natural gas market. "Order No. 636 establishes a new policy on a national basis that usage charges on competing pipelines should be a neutral factor in competition between gas sellers."<sup>43</sup> By forcing the pipeline companies to provide unbundled services,<sup>44</sup> the Commission hoped to achieve a competitive market.

36. See *id.*

37. See *id.*

38. This clause has come to be called the "Memphis Clause." *Union Pac.*, 129 F.3d at 160.

39. The Court explained the difference between this case and *Mobile* by saying:

The important and indeed decisive difference between this case and *Mobile* is that in *Mobile* one party to a contract was asserting that the Natural Gas Act somehow gave it the right unilaterally to abrogate its contractual undertaking, whereas here [Texas Gas] seeks simply to assert, in accordance with the procedures specified by the Act, rights expressly reserved to it by contract.

*Memphis Light, Gas, & Water Div.*, 358 U.S. 107 at 112.

40. See *Union Pac.*, 129 F.3d at 161.

41. See generally Robert J. Michaels, *The New Age of Natural Gas How the Regulators Brought Competition*, REGULATION MAGAZINE <<http://www.cato.org/pubs/regulation/reg16n1e.html>> (visited Feb. 11, 1998) (providing an overview of the history of natural gas regulation and the progression towards deregulation).

42. Order No. 436 imposed an open access commitment on pipelines wanting to provide gas transportation. See Order No. 436, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, III F.E.R.C. STATS & REGS. ¶ 30,665, 50 Fed. Reg. 51,844 (1985); see also Order No. 500, *Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol*, III F.E.R.C. STAT & REG. ¶ 30,761, 52 Fed. Reg. 30,334 (1987). For a general discussion of Order No. 436 and Order No. 500, see William A. Mogel, *A History of Regulation of The Natural Gas Industry*, in *Fifth Annual Federal Energy Regulation Conference Materials* (October 30, 1992) at 20-35.

43. *Kern River Transmission Co. Order Accepting Revised Compliance Filing, Denying Rehearing and Granting Clarification* 64 F.E.R.C. ¶ 61,049 at 61,414. (1993).

44. Unbundling is "separation of transportation, sales and storage services by an interstate pipeline as

The Commission believed Order No. 636 would facilitate the move away from regulation and towards competition in the natural gas market.<sup>45</sup>

Pipeline charges consist of the reservation or demand charge,<sup>46</sup> and the usage charge.<sup>47</sup> The reservation charge must be paid to reserve space in the pipeline for an agreed upon period. This fee is for renting the capacity to transport gas regardless of the amount of gas actually transported. The usage charge is paid when the gas is transported. In theory, by removing the fixed costs from the pipeline usage charge and placing it in the reservation charge, the usage charge of the pipeline is lowered to a point where it is inconsequential to the overall price, thereby facilitating competition.<sup>48</sup>

One part of Order No. 636 was the mandatory requirement that interstate pipelines use the Straight Fixed Variable ("SFV")<sup>49</sup> rate design.<sup>50</sup> Due to Order No. 636, "interstate pipelines are [now] required to use [the] SFV method for cost classification, allocation and rate design so as to recover all fixed costs in the reservation charge portion of a two part transportation rate."<sup>51</sup> If a company using the pipeline actually transports all the gas reserved in the reservation charge, the rate method is of no consequence to the total price.<sup>52</sup> The rate method becomes a factor only when the amount of gas reserved exceeds the amount transported. Unlike the Modified Fixed Variable, a pipeline using the SFV rate is assured of recovering all of its fixed cost regardless of how much gas is transported. The SFV is a pipeline-friendly rate method.

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mandated by . . . Order No. 636." Joint Initial Brief of Petitioners at xvii, *Union Pac.* (93-1463).

45. See 57 Fed. Reg. 13,267 at 13,268 (1992).

46. A Reservation Charge is a "demand charge for reserving firm transportation capacity on a pipeline whether or not gas is actually transported." Joint Initial Brief of Petitioners at xvi, *Union Pac.* (93-1463).

Where the customer purchases firm service, a pipeline may impose a reservation fee or charge on a shipper as a condition of service . . . [i]f a reservation fee is charged, it must recover all fixed costs attributable to the firm transportation service, unless the Commission permits the pipeline to recover the fixed costs in the volumetric portion of the two-part rate.

157.18 C.F.R. § 284.8 (d).

47. Usage Charge is "[a] commodity charge applied to the amount of gas actually transported." Joint Initial Brief of Petitioners at xvi, *Union Pac.* (93-1463).

48. See 57 Fed. Reg. 13,267 at 13,268.

49. See 57 Fed. Reg. 13,267 at 13,295. In a Straight fixed /Variable (SFV) rate design, "all fixed costs are assigned to the reservation charge, which does not vary with use, and all variable costs are assigned to the usage charge, which does [vary according to use]." *Union Pac.*, 129 F.3d at 159.

50. Rate Design is "[t]he method of classifying pipeline fixed and variable costs between reservation and usage charges, resulting in the allocation of such costs over projected volumes of service to determine the specific rates to be charged for such services." Joint Initial Brief of Petitioners at xvi, *Union Pac.* (93-1463).

51. *Kern River Gas Transmission Co.*, 62 F.E.R.C. ¶ 61,191, 62,254. Fixed Costs are "[c]osts included in the cost of service of a pipeline which does not tend to fluctuate with the amount of natural gas flowing through the system." Joint Initial Brief of Petitioners at xvi, *Union Pac.* (93-1463).

52. Kern River's Transmittal Letter explained the rate making process as follows:

[T]he Commission has often recognized, a rate design change is not properly considered as a discount. Rather, as the last step in the rate making process, differing rate designs may be employed to collect the same revenue requirement, but the amount to be collected is not intended to change as a result. Indeed, depending on a customer's usage levels, a rate design change could result in an increased level of overall charges.

Deferred Joint Appendix at 10, 11, *Union Pac.* (93-1463).

### III. STATEMENT OF THE CASE

#### A. *Background Facts of Union Pacific Fuels, Inc. v. FERC*

Prior to the promulgation of Order No. 636, the Kern River Gas Transmission Company ("Kern River") proposed to construct and operate an interstate pipeline from Wyoming to California.<sup>53</sup> In 1985, Kern River, as required by section 7 of the Natural Gas Act,<sup>54</sup> submitted a traditional application<sup>55</sup> to the FERC requesting certificate to construct a pipeline.<sup>56</sup> WyCal, a competitor of Kern River, submitted an optional expedited certificate procedure ("OECF")<sup>57</sup> proposal for pipeline construction and operation. WyCal's plan proposed to cover the same geographic area and function in the same manner as Kern River's proposal. By using an OECF, WyCal had an opportunity to obtain approval before Kern River could complete the traditional section 7 process.

Because Kern River did not want to lose the project to a competitor, it chose to abandon the traditional NGA section 7 application process and also submit an OECF for FERC approval.<sup>58</sup> The OECF places the risk of the project on the pipeline, in this case, Kern River. The Kern River project was approved by the FERC on January 24, 1990, and Kern River commenced construction of the pipeline.<sup>59</sup>

Several companies negotiated contracts with Kern River for use of the pipeline shortly before its approval. The contracts at issue were signed by Union Pacific Fuels ("Union Pacific") and Mobile on December 15, 1989. These negotiated fifteen-year contracts mandated use of a Modified Fixed Variable Rate ("MFV").<sup>60</sup>

An understanding of two specific clauses in the Union Pacific contract is necessary to properly analyze the FERC's decision. First, the contract states that neither party is allowed to seek a unilateral change to the contractual rate. Specifically, the contract states, "notwithstanding the foregoing, neither Shipper nor Transporter shall without the consent of the other party seek to change as to

53. See 62 F.E.R.C. ¶ 61,191 at 62,251.

54. See 18 C.F.R. §§ 157.100-157.106 (1998).

55. A traditional application process takes longer and requires additional work and risk to the pipeline. Unlike the traditional application, with the optional certificate ("OECF") the applicant is "not required to prove the public convenience and necessity in the areas of adequate supply, adequate markets, facilities, and cost of construction." Joint Initial Brief of Petitioners at 8-9 *Union Pac.* (93-1463).

56. Mojave Pipeline Company submitted a traditional application for pipeline construction at the same time in the same location. The Commission consolidated Kern River and Mojave's request for pipeline construction. 50 F.E.R.C. ¶ 61,069 at 61,141.

57. Established in Order No. 436. "A pipeline is eligible for an optional certificate if it agrees to provide nondiscriminatory open access transportation . . . and if it is willing to assume the economic risk of the project . . ." *Id.* at 61,149.

58. See *Union Pac.*, 129 F.3d at 160.

59. 50 F.E.R.C. ¶ 61,069.

60. Deferred Joint Appendix at 33, *Union Pac.* (93-1463). In the Modified Fixed Variable rate design, "some of the fixed costs are assigned to the reservation charge, but some of the fixed costs, including return on equity and income taxes, are assigned to the usage charge along with the variable costs." *Union Pac.*, 129 F.3d at 159.



shipper the modified fixed variable rate design.”<sup>61</sup> The language expresses an intent between Union Pacific and Kern River, which was part of the bargain, to keep the contracted rate structure in place.

Another clause at issue in the Union Pacific contract acknowledges possible FERC interference with the contract. The clause, which anticipates FERC intervention of the contract with regard to the rate structure, is known as a *Memphis Clause*.<sup>62</sup> The *Memphis Clause* in the Union Pacific contract stated, “if [the] FERC requires a change in cost allocation, classification, or rate design as to the rates for service on Transporter’s System, then Transporter shall have the right to immediately reflect any necessary changes in this Agreement, including any reallocation of costs . . . .”<sup>63</sup> This clause, which was standard to gas contracts prior to Order No. 636 became an issue after the FERC promulgated the order.

### B. The Effect of Order No. 636 on Kern River

In order to “ensure that transportation service is equal in quality for all gas supplies,”<sup>64</sup> the Commission, in 1993, promulgated Order No. 636. Shortly thereafter, Kern River requested for the Commission to implement Order No. 636 and change the rate method from a MFV to a SFV.<sup>65</sup> The difference between a MFV and a SFV rate is the time at which the fixed rates will be charged to the user of the transportation system. If the pipeline user does not expect to transport one-hundred percent of the amount it reserved, the MFV is better. If it intends to transport the total gas it reserves, it does not make any difference, either method is appropriate. The change to the SFV would have benefitted Kern River, since it could recover all fixed costs in the reservation charge, regardless of the amount of gas transported, rather than recover the fixed costs in the usage charge.

The MFV rate method places less risk on Union Pacific and Mobile than a SFV rate. With the MFV, the company using the pipeline would not have to pay *all* fixed costs in the reservation charge; thus, exact estimates of usage are not necessary. Mobile and Union Pacific wanted their rate method to remain at MFV. Because the intention at the time of the contracts was to maintain a MFV rate method, which was included in part of the contractual language, Kern River requested that Mobile and Union Pacific’s rate method remain at MFV.<sup>66</sup>

If Union Pacific and Mobile were allowed to retain a MFV rate method, other Kern River customers argued that it would be unfair. These companies

61. Deferred Joint Appendix at 33, *Union Pac.* (93-1463).

62. The *Memphis Clause* expresses both parties acknowledgment that the price is subject to FERC regulation. *Union Pac.*, 129 F.3d at 160, 161.

63. Deferred Joint Appendix at 33, *Union Pac.* (93-1463).

64. Order No. 636., *supra* note 6.

65. *See id.*

66. Mobile and Union Pacific argued that “[C.F.R. §] 284.8(d) as amended by Order No. 636 . . . reflects the ability of the FERC to grant a waiver from the SFV rate design.” Joint Reply Brief of Petitioners at 11, *Union Pac.* (93-1463).

wanted the rate method to remain at MFV for all Kern River customers. Some companies in contractual relations with Kern River had provisions in their contracts mandating that Kern River could not charge them a higher rate than any other customer.<sup>67</sup> Thus, if Kern River lowered its rates for Mobile and Union Pacific, it would have to lower rates for companies with this contractual provision. The inverse is also true. Kern River could not raise rates for these companies without raising the rates for Union Pacific and Mobile. Understandably, such companies argued that if the Commission granted Kern River's rate change, it would likewise be an unfair exercise of its authority.<sup>68</sup>

"[I]n order to achieve the broad public interest goals, underlying the Commission's SFV policy, of minimizing distortions in the wellhead market and thereby benefitting all gas consumers through lower prices and more abundant supplies,"<sup>69</sup> the Commission allowed Kern River to implement the rate change method from MFV to SFV. However, it said the rate change would be administered on all contracts, including the contracts with Mobile and Union Pacific Fuels.<sup>70</sup> The Commission explained that it would be unfair to implement a rate change impacting companies with "most favored nation" status, while allowing Mobile and Union Pacific to escape the change. The FERC stated that it would be unduly discriminatory to retain MFV rates for Mobile and Union Pacific and run counter to the Commission's original goals of switching to uniform implementation of SFV.<sup>71</sup>

The FERC pointed out that keeping the rates at MFV would be contrary to the policy reasons for the enactment of Order No. 636 primarily trying to increase competition at the wellhead. The FERC explained the competition between Kern River and its competitors would be unfair, since its usage rates would be higher, and would contribute to market distortions.<sup>72</sup> They explained that if Kern River were allowed to keep the MFV rate, its usage rates would be \$0.1852 per cubic foot. In comparison, the usage charge of Kern River's competitors who used the SFV, would be \$0.0165 per cubic foot.<sup>73</sup> According to the FERC, the passage of Order No. 636 was meant to prevent this type of competitive distortion.<sup>74</sup>

### C. Procedural History Of Union Pacific Fuels, Inc. v. FERC

After the FERC issued its rule imposing a SFV rate method on Kern River's customers, including Mobile and Union Pacific, the parties affected by

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67. See *Union Pac.*, 129 F.3d at 161.

68. See *id.*

69. *D.C. Circuit Affirms FERC's Refusal To Allow Exceptions To SFV Rate Design In Kern River Order No. 636 Restructuring Case*, FOSTER NATURAL GAS REPORT, (Foster Associates) Report No. 2157, 1997 WL 10342889 (quoting the FERC).

70. See 62 F.E.R.C. ¶ 61,191 at 62,261.

71. See *id.*

72. See *id.*

73. See *id.*

74. See *id.*

the FERC's decision appealed to the District of Columbia Circuit Court of Appeals. The parties claimed the Commission exceeded its authority by abrogating rates of private contracts and failed to consider their intentions that the rate structure remain at MFV.<sup>75</sup> The cases were consolidated into one case, which is represented by Union Pacific Fuels Inc.<sup>76</sup>

#### IV. ANALYSIS

The court in *Union Pacific* began by analyzing the FERC's decision to change Kern River's rate method to SFV. It evaluated the decision to change the rate method to determine whether the FERC's action was arbitrary and capricious.<sup>77</sup> In addition to the "arbitrary and capricious" standard, Union Pacific and Mobile argued that the FERC must also meet the higher standard of *Mobile-Sierra*.<sup>78</sup> As previously discussed, under the *Mobile-Sierra* doctrine the FERC may only abrogate a private contract if public interest demands. The court concluded the determination of whether the *Mobile-Sierra* doctrine applies is dependant on the interpretation of the parties' contract.<sup>79</sup> The court gave complete deference to the contract language, not the parties' intent in drafting the contract. It is the parties' decision, the court explained, to include or exclude language that contemplates intervention by the FERC.<sup>80</sup>

The court in *Union Pacific* envisioned three possible types of contract construction.<sup>81</sup> First, the contract may be drafted to permit rate changes but provide for the FERC to review such changes. Second, it may be drafted to restrict the power of the FERC and allow a change only if the rates are contrary to the public interest.<sup>82</sup> This approach would incorporate the *Mobile-Sierra* doctrine into the contract. Lastly, the contract, may be written to allow the FERC to change rate methods that are against public interest; it could allow change if the rate is unjust or unreasonable.<sup>83</sup> Instead of using one of these types of contracts, Union Pacific left the interpretation to the Commission.

The contracts at issue in *Union Pacific* included language anticipating intervention by the FERC, in other words, a *Memphis Clause*.<sup>84</sup> The court determined this anticipation of intervention rendered *Mobile-Sierra* inapplica-

75. See *Union Pac.*, 129 F.3d at 159.

76. Consolidation reflects the interest of the following parties: Union Pacific Fuels, Inc., Chevron U.S.A., Inc., Mobile Exploration & Producing U.S., Shell Western E&P Inc., Southern California Utility Power Pool, and Imperial Irrigation District. Joint Initial Brief of Petitioners at i, *Union Pac.* (93-1463).

77. See 5 U.S.C. § 706(2)(A) (1994) (stating that if a court of law is reviewing an agency action, the court shall "hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law").

78. See *Mobile-Sierra* doctrine *supra* note 3.

79. See *Union Pac.*, 129 F.3d at 161.

80. See *id.*

81. See *id.*

82. See *id.*

83. See *id.* (quoting *Papago v. Tribal Util. Auth. v. FERC*, 723 F.2d 950, 953 (D.C. Cir. 1983)).

84. See *Union Pac.*, 129 F.3d at 161.

ble.<sup>85</sup> “While [Union Pacific and Mobile] protest that boilerplate language acknowledging rate changes by the FERC should not render the *Mobile-Sierra* doctrine inapplicable . . . they do not explain why they could not have adopted language that would simply and clearly have invoked *Mobile-Sierra*.”<sup>86</sup> If Union Pacific wanted to keep the FERC from interfering with the contract unless public interest demands, they should have drafted their contract to clearly adopt this doctrine.

An argument can be made that the FERC was using its authority to interfere with the private contracts between Kern River, Union Pacific, and Mobile. The parties clearly agreed to no unilateral attempts to seek a rate modification (of their contract) from the FERC. Since the end result allows the FERC to change the intentions of the parties, one could argue that the FERC exceeded its powers and abrogated the private contracts. If there was a true abrogation of the contracts, the FERC would have to give reasons why the public interest would demand such an abrogation.<sup>87</sup>

However, there is merit to the argument that the FERC went no further than the language of the contract dictated and did not exceed its authority. This is just the opposite of what Union Pacific and Mobile argued. The FERC did not alter the *Mobile-Sierra* doctrine; it is alive and well. The court strictly enforced the language of the contract which allowed the FERC to intervene, while neglecting the parties’ intentions to keep the rate method at a MFV. None of the parties to the contract sought a change in the rate structure. Kern River sought modification of rates regarding other parties, *not* Union Pacific or Mobile. Therefore, Kern River did not breach its contract with either Mobile or Union Pacific. The intentions of the parties to keep the rate method were not clearly expressed in the language of the contract since there was a conflict with the *Memphis Clause*. Because of this conflict, the FERC made its decision based on what would be best to advance competition in the natural gas market.

After *Union Pacific*, the Commission must still abide by the language of the contract, unless they find it to be against the public interest.<sup>88</sup> By enforcing the words of the parties’ contract, the court encourages careful drafting of natural gas contracts to ensure that their intentions remain clear.

While it is encouraging that the court gave deference to the contract between the parties, it is somewhat alarming that the parties’ intentions were ignored. Although the *Mobile-Sierra* doctrine gives contracting parties limited protection against FERC intervention, that protection can be minimized if the contract anticipates FERC intervention by including a *Memphis Clause*. The FERC indicates that the *Memphis Clause* trumps any other express provision in the contract.

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85. *See id.*

86. *Id.* at 161-162.

87. In this case, the FERC’s position was that promoting competition in the natural gas market was a sufficient reason to qualify for a public interest demand.

88. *See Mobile-Sierra* doctrine, *supra* note 3.

Here, the court strictly enforced the words of the contract without looking further to determine the intentions of the parties. Although the contract language did not reflect the allocation of risk that was bargained for, a general rule exists that a party is responsible for the language that is in the contract. A claim that the language anticipating intervention by the FERC was simply boilerplate language is no excuse for exemption from the terms of the contract.<sup>89</sup> The power of the FERC should not be curtailed due to a party's failure to properly draft a contract. This case reflects a willingness of the Commission to allow the language of the contract to prevail in cases where requests are made. As the Court stated in *Mobile*, "preserving the integrity of contracts, . . . permits the stability of supply arrangements which all agree is essential to the health of the natural gas industry."<sup>90</sup> It will be the parties to the contract who control their relationship.

## V. CONCLUSION

*Union Pacific* provides an example of what can occur if the FERC's intervention is not specifically addressed in the natural gas transportation contract. The court stressed that although the parties to the contract intended to refrain from unilateral requests to change the rate design, more weight will be given to the *Memphis Clause*. The court sent a message to those drafting natural gas transportation contracts that when clauses in a contract conflict, the FERC will enforce the provision that best reflects the public interest demands such as the *Memphis Clause*.<sup>91</sup> "The parties could have, but did not adopt language that expressly limited the FERC's right to change modified fixed variable [MFV] to the public interest standard required by *Mobile-Sierra*."<sup>92</sup> A lesson to learn from *Union Pacific* is to be specific when drafting a natural gas contract. If the drafter wishes for the *Mobile-Sierra* doctrine to apply to the contract, it should be included in the language of the contract. When writing the natural gas transportation contract, there is no better way to preserve the contracting parties intentions than to draft the contract language in a clear and specific manner.

Harold Glenn Drain

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89. "One having the capacity to understand a written document who reads it, or, without reading it or having it read to him, signs it, is bound by his signature." HORNBOOK ON CONTRACTS, *supra* note 1, at 410. (quoting *Rossi v. Douglas*, 100 A.2d 3, 7 (1953)).

90. See *Mobile Gas Corp.*, 350 U.S. at 344.

91. See *Union Pac.*, 129 F.3d at 161.

92. *Id.*